KASNEB

CIFA PART I SECTION 2

FINANCIAL INSTITUTIONS AND MARKETS

WEDNESDAY: 23 November 2016. **Time Allowed: 3 hours.**

Answer any FIVE questions. ALL questions carry equal marks. Show ALL your workings.

QUESTION ONE

(a) Explain four benefits of credit reference bureaus (CRB) to an economy. (8 marks)

(b) Discuss three sources of private equity investments. (6 marks)

(c) Bond portfolio managers of financial institutions commonly follow a specific strategy for investing in bonds.

In the context of the above statement, explain the following strategies:

(i) Matching strategy. (2 marks)

(ii) Laddered strategy. (2 marks)

(iii) Barbell strategy. (2 marks)

(Total: 20 marks)

QUESTION TWO

(a) Define the term "moral hazard" as used in financial institutions. (2 marks)

(b) Explain the effect of moral hazard on:

(i) Credit rationing. (4 marks)

(ii) Adverse selection. (4 marks)

(c) An investor buys stock on margin and holds the position for exactly one year.

Shares purchased	700
Purchase price	Sh.22 per share
Call money rate	4%
Dividend paid	Sh.0.60 per share
Leverage ratio	1.6
Total return on the investment	12%

The interest on the loan and the dividends are both paid at the end of the year.

Required:
The price at which the investor sold the stock. (6 marks)

(d) A banker's acceptance has an all-inclusive annual rate of 5.25% for a one month loan of Sh.2 million.

Required:
The effective annualised cost. (4 marks)

(Total: 20 marks)

QUESTION THREE

(a) Distinguish between the following set of terms:

(i) "Sell-side analyst" and "buy-side analyst". (4 marks)

(ii) "Principal trade" and "portfolio trade". (4 marks)

(b) Discuss three attributes of a well constructed security market index. (6 marks)

(c) The following information relates to two stocks, A and B:

Average return for stock A	20%
Average return for stock B	16%
Average risk-free rate	8%
Standard deviation of stock A	14%
Standard deviation of stock B	6%
Stock beta for stock A	1.8
Stock beta for stock B	0.9

Required:

(i) Treynor's index for each of the stocks. (4 marks)

(ii) Based on the result in (c) (i) above, advise a prospective investor on which stock to invest in. (2 marks)

(Total: 20 marks)

QUESTION FOUR

(a) In relation to financial markets, distinguish between the following set of terms:

(i) "Eurobond" and "junkbond". (4 marks)

(ii) "Mutual fund" and "hedge fund". (4 marks)

(b) Describe three ways in which operators in the informal finance sector select their clients. (6 marks)

(c) Four companies which are listed in a stock exchange belong to a group. The cross holding of these companies are as follows:

1. Company A owns 20% of company B and 10% of company C.
2. Company B owns 15% of company C.
3. Company C owns 10% of company A, 10% of company B and 5% of company D.
4. Company D has no ownership in any of the other three companies.
5. Each company has a market capitalisation of Sh.50 million.

Required:

The market capitalisation after adjusting for free float. (6 marks)

(Total: 20 marks)

QUESTION FIVE

(a) An asset management firm wants to purchase 500,000 shares of a company. It decides to shop the order from various broker/dealer firms to identify which firm can offer the best service at lowest cost.

Required:

Discuss two potential negatives of shopping the order. (4 marks)

(b) An investor decides to sell short 10,000 shares of XYZ Ltd. when it is selling at its yearly high of Sh.56. The broker has a margin requirement of 45% and the commission on the purchase is Sh.15,500. While holding the position, XYZ Ltd. pays a dividend of Sh.2.50 per share. One year later, the investor purchases 10,000 shares at Sh.45 to close out the position and the broker charges a commission of Sh.14,500 and 8% interest on the money borrowed.

Required:

The rate of return on the investment. (6 marks)

(c) (i) Differentiate between "electronic communication networks" and "electronic crossing networks". (4 marks)

(ii) Highlight two disadvantages of electronic crossing networks. (2 marks)

(d) Explain four challenges of bank marketing. (4 marks)

(Total: 20 marks)

QUESTION SIX

(a) Discuss five instruments traded in the secondary mortgage market. (10 marks)

(b) A futures contract on a treasury bill expires in 60 days. The treasury bill matures in 140 days and the discount rates on the treasury bills are as follows:

Treasury bills	**Discount rates**
60-day treasury bill	10 %
140-day treasury bill	8%

Use 365 days in a year.

Required:

(i) The appropriate futures price using the prices of the 60-day and 140-day treasury bills. (4 marks)

(ii) The futures price of the underlying spot price compounded at the appropriate risk free rate. (4 marks)

(iii) Convert the futures price to the implied discount rate on the futures. (2 marks)

(Total: 20 marks)

QUESTION SEVEN

(a) Describe three reasons for buying and selling foreign exchange. (6 marks)

(b) Discuss three reasons why investors prefer futures market over the cash market trading vehicles. (6 marks)

(c) Richard Kiti opened a margin account at Maximin Securities Ltd. Kiti started trading in securities by purchasing 400 Green Tea Ltd's shares on margin at Sh.80. In order to complete this purchase, Kiti borrowed Sh.6,000 from the broker.

Required:

(i) Actual margin in Kiti's account at the time of purchase. (2 marks)

(ii) Actual margin in Kiti's account, if the share price rises to Sh.120. (2 marks)

(iii) Actual margin in Kiti's account, if the share price drops to Sh.70. (2 marks)

(iv) Using the results obtained in (c) (i) above and a maintenance margin of 50%, compute the price that the share should drop to in order for Kiti to receive a margin call. (2 marks)

(Total: 20 marks)

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